*United States Court of Appeals*

*for the Second Circuit*

# APPELLANT'S BRIEF

75-4127

No. 75-4127

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

THE EDISON CLUB,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

BRIEF
OF APPELLANT

P
P/S

J.P. JANETATOS
ROBERT A. FESJIAN
815 Connecticut Avenue, N.W.
Washington, D.C. 20006
Counsel for Petitioner-Appellant
The Edison Club



Of Counsel:
BAKER & MCKENZIE

BRIEF OF APPELLANT

TABLE OF CONTENTS

# CITATIONS

Page

Cases (continued):



Statutes:



Regulations:



Rulings:

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 75-4127

THE EDISON CLUB,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

1. Jurisdiction

Jurisdiction of the appeal of taxpayer is in this Court by virtue of section 7482(a) of the Internal Revenue Code of 1954.[1/]

2. Statement of the Issues Presented

2.1. Principal Issue

The principal issue presented is whether the Tax Court erred in holding that amounts received by taxpayer as "assessments" from its members during the taxable years 1967 and 1968 were not contributions to capital so as to be excludable from gross income under section 118.

1/ Hereinafter, all statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

2.2. Subsidiary Issue

A subsidiary issue presented is whether the Tax Court erred in holding that taxpayer is liable for an addition to tax for the taxable year 1967 under section 6651. The resolution of the principal issue will be determinative of the resolution of the subsidiary issue.

3. Statement of the Case

3.1. Procedural Aspects

This appeal involves deficiencies in tax initially determined by the Commissioner in taxpayer's income tax for the taxable years 1967 and 1968. (R. 9-13)[2/] The Tax Court's memorandum findings of fact and opinion (R. 153-206), which are unofficially reported at CCH Tax Ct. Mem., Dec. 33,030(M), were filed on February 6, 1975. Subsequent to a hearing pursuant to Tax Court Rule 155, the Tax Court's decision was formally entered on March 14, 1975. (R. 216) Taxpayer timely filed the notice of appeal on June 3, 1975. (R. 217)

The facts, as found by the Tax Court and as otherwise disclosed in the record, are summarized hereinbelow.

---

2/ "R." references are to the separately bound record appendix. "Ex. Vol." references are to the separately bound exhibit volume.

3.2. Background

Taxpayer was a New York corporation originally organized under the Membership Corporations Law of New York. (R. 15, 154)

Taxpayer owned and operated its facilities as a social and recreational club primarily for the benefit of its members. (R. 15, 155) However, it also derived substantial income from the use of its facilities by nonmembers. (R.15, 155) Taxpayer was originally begun for employees of the General Electric Company, but later was open to others as well. (R. 155) From 1928 until 1968, taxpayer leased the land upon which its facilities were located, first from the General Electric Company, and later from the General Electric Company's subsidiary, General Electric Realty Corporation. (R. 16, 155-156)

At all times material herein, taxpayer's members consisted of regular members, associate members, house members, women members, junior members #1, #2, and #3, and pool members. (R. 16, 156) The right to vote and to hold office was restricted to the regular members. (R. 156) Only the employees of General Electric Company were admitted as regular members. (R. 156) Pursuant to its constitution, ownership

of taxpayer was vested in the regular members. (R. 156; Ex. Vol. 41) Admission of an individual to membership in taxpayer involved a detailed and personalized procedure including sponsoring and seconding, examination of the prospective member's background, informal lunch or dinner interviews, and special cocktail parties. (R. 92-93)

On December 21, 1965, the Internal Revenue Service advised taxpayer that its qualification for exemption from Federal income tax as an organization defined in section 501(c)(7) was revoked for all taxable years subsequent to March 31, 1959. (R. 15, 168)

3.3. <u>Assessment Policy</u>

Taxpayer's bylaws gave its board of directors authority to levy annual assessments provided that any annual assessments exceeding $100 per member had to be ratified and approved by taxpayer's members at the annual meeting or at a special meeting before becoming effective. (Ex. Vol. 44) Pursuant to this authority and at least as early as 1959, taxpayer's dues structure included from time to time an additional charge designated as an "assessment", the purpose of which was to provide funds for capital improvements and other expenditures. (R. 160, Ex. Vol. 59-60)

In the spring of each year taxpayer's board of directors would prepare and distribute to members a dues structure which made provision for dues, initiation fees, assessments, and taxes. (R. 161-166, 169-175; Ex. Vol. 25-28, 110) A letter from taxpayer's president would accompany each dues structure and, among other things, would explain taxpayer's plans and fiscal needs for the coming year. (R. 164-165, 173-174; Ex. Vol. 88-96)

The dues structure sent to taxpayer's members for the taxable year 1967 set forth in separate columns dues, assessments, taxes, and initiation fees. (R. 18, 166; Ex. Vol. 25) The dues structure for the taxable years 1966, 1969, 1970 and 1971 displayed similar breakdowns. (R. 18, 23; Ex. Vol. 25, 27-28, 110) The dues structure for the taxable year 1968 listed separately only two amounts, "Dues" and "Taxes". (R. 175, Ex. Vol. 26) However, taxpayer's president's letter accompanying this dues structure stated that "You will note that the attached dues schedule is identical with the one which had been scheduled to go into effect April of 1966 with two exceptions". (R. 174; Ex. Vol. 96) The exceptions related to minor changes in the dues structure for women, seniors, and juniors. (R. 174; Ex. Vol. 96)

All taxpayer's receipts were deposited in its general checking account. (R. 177) Under taxpayer's accounting system amounts received by taxpayer in respect of assessments would be credited to account number 501 in taxpayer's general ledger. (R. 35-71, 178-180; Ex. Vol. 30A-31A) During the taxable year 1967, the amount of $38,925.48 was credited to the 501 account in the general ledger. (R. 17, 180) During the taxable year 1968, the amount of $38,254.82 was credited to the 501 account in the general ledger (R. 17, 180)

3.4. Purchase of Taxpayer's Premises

In the years prior to 1968 taxpayer's representatives were attempting to negotiate with General Electric Realty Corporation for the purchase of the real property used by taxpayer. (R. 16, 167) On August 28, 1967, taxpayer extended a formal offer to General Electric Realty Corporation to purchase the real property used by taxpayer. (R. 16, 189) On December 29, 1967, General Electric Realty Corporation advised taxpayer that this offer to purchase would be accepted. (R. 16, 189) Taxpayer's acquisition of the real property it used was completed by the end of March 1968. (R. 16, 189)

In anticipation of the purchase of the real property it used, taxpayer established in early 1966 an interest-bearing savings account at the Schenectady Savings Bank. (R. 16, 169 ; Ex. Vol. 74-77) Amounts in this account were to be earmarked for the down payment of the purchase price of the real property used by taxpayer. (R. 16, 169) During the taxable years 1967 and 1968, there were deposited in this savings account $43,109.95 and $39,396.31, respectively. (R. 179; Ex. Vol. 75-77)

Taxpayer made deposits in the savings account approximately once a month. (Ex. Vol. 75-77) As a general rule, when assessments were posted from taxpayer's general journal to its general ledger there would also be an actual transfer of corresponding amounts from taxpayer's checking account to the savings account. (R. 62, 67; Ex. Vol. 29-31A, 75-77) It was the understanding of individuals in taxpayer's accounting department that amounts corresponding to assessments were to be deposited monthly in the savings account and were to be segregated from amounts in taxpayer's checking account. (R. 62, 67) From the date of the opening of the savings account through the taxable year 1968 the amounts deposited monthly in the savings account corresponded closely, but did not equal exactly, the monthly credits to the assessments

account in the general journal. (Ex. Vol. 29-31A) Beginning in the taxable year 1969 the credits to the assessments account corresponded exactly to the deposits in the savings account. (Ex. Vol. 29-31A)

On or about March 27, 1968, taxpayer withdrew the sum of $70,000 from the savings account in the Schenectady Savings Bank to make a down payment on the purchase price for the real property it used. (R. 70, 86, 87, 179, 189; Ex. Vol. 76) The withdrawal from the savings account was deposited in taxpayer's checking account. (R. 86, 87) Taxpayer then drew a check upon the checking account payable to the order of General Electric Realty Corporation to cover the down payment. (R. 70; Ex. Vol. 97-99) As a result of this withdrawal there remained in the savings account on March 31, 1968, a balance of $12,506.26. (R. 179; Ex. Vol. 76)

3.5. Capital Improvements Program

Before, during, and after the taxable years in issue taxpayer had a capital improvements program under which it continually improved its physical plant. (R. 163-165, 167, 171, 173-174) The improvements under this program included conversion of rooms, purchases of furniture and machinery, and installation of new electrical facilities. (R. 164, 171)

During each of the taxable years 1967 and 1968 there was debited to taxpayer's Plant and Equipment account $22,708.69 and $23,390.72, respectively, as amounts accrued for capital expenditures or additions. (R. 180) This account also reflected credits on account of the retirement of capital assets arising from scrapping, trade-ins, and the like of $8,933.23 and $17,925.40 for the taxable years 1967 and 1968, respectively. (R. 180)

During the taxable years 1967 and 1968 taxpayer also redeemed swimming pool bonds in the amounts of $17,502.18 and $6,496.80, respectively. (R. 150-152)

3.6. Notice to and Assent of Members

Applicants for membership in taxpayer acknowledged on their membership application forms that if admitted to membership, they understood that initiation fees, dues, and assessments were subject to change. (Ex. Vol. 28A) In addition, Article V, Section D(1) of taxpayer's bylaws as set forth in a booklet given to members further informed members that taxpayer's board of directors could, at its discretion, assess members, provided, however, that annual assessments in excess of $100 would have to be approved by taxpayer's members before becoming effective. (R. 19; Ex. Vol. 44) During all relevant taxable years here the annual assessments never

exceeded $100. (Ex. Vol. 25-28, 110)

Operating statements printed on announcements of taxpayer's annual meetings mailed to each of taxpayer's members clearly separated dues from initiation fees and assessments (or capital improvements) for all years relevant here. (R. 21; Ex. Vol. 79, 81, 83, 85 - 87) It was specifically stipulated by the parties that such announcements were sent to taxpayer's members. (R. 21)

At the beginning of each of taxpayer's taxable years taxpayer would mail a dues structure to each of its members. (R. 18, 23; Ex. Vol. 25-28, 110) Each of these dues structures (except for the dues structure for the taxable year 1968) separated charges for dues from charges for assessments. (Ex. Vol. 25-28, 110) Members of taxpayer's board of directors often discussed the dues structures with non-board members. (R. 137)

By reason of letters from taxpayer to its members, the members were continually informed that assessments were levied to finance capital improvements. (R. 164, 165, 173, 174; Ex. Vol. 88-96) For example, in 1962 taxpayer's president explained to taxpayer's members that the "assessment is limited to Capital Improvements and is tax free on this basis.

These amounts will not be used in the over-all operation of the Club". (R. 21; Ex. Vol. 89)

As early as January 1965, taxpayer's members were advised at taxpayer's annual meeting that taxpayer's decision to purchase rather than to continue leasing its facilities from the General Electric group would necessitate a dues and assessment increase as of April 1, 1965. (R. 164-165; Ex. Vol. 92) Pending negotiations between taxpayer and the General Electric Realty Corporation for the purchase of the real property used by taxpayer, taxpayer's members were continually informed of the progress of the negotiations. (R. 167-169, 171, 173-174) Thus, at taxpayer's annual meeting at the end of 1965 the members were informed that approximately $80,000 would have to be accrued for the contemplated purchase. (R. 167) The status of the negotiations as well as the setting aside of funds for the purchase of the real property used by taxpayer were also discussed at the 1966 and 1967 annual meetings. (R. 171; Ex. Vol. 69A) In addition, taxpayer's members were specifically notified by letter in March 1967 that taxpayer had begun setting aside funds for the purpose of purchasing the real property used by taxpayer. (R. 173; Ex. Vol. 95)

Taxpayer prepared a Balance Sheet and Statement of Revenue and Expenses for distribution to its membership (R. 182) For the taxable years 1967 and 1968 these Balance Sheets informed the membership that taxpayer had $43,110 and $12,506, respectively, in the purchase account for the real property used by taxpayer. (R. 183, 186) For the taxable year 1968 the applicable Balance Sheet indicated that as of February 1968 taxpayer had $81,527 in the same purchase account (R. 186) For the taxable year 1967 the Statement of Revenue and Expenses stated that taxpayer had received $38,925 as "Club Assessment". (R. 184) For the taxable year 1968 the Statement of Revenue and Expenses stated that taxpayer took in $277,140 as "Club Dues and Assessments" (R. 187)

In four separate instances at trial taxpayer attempted to present testimony to show that taxpayer's members intended and knew that amounts they paid to taxpayer as assessments were to be set aside for capital improvements and for the purpose of purchasing the real property that taxpayer used. (R. 113, 131, 133, 138) In each of these instances the Tax Court sustained the Commissioner's objection to the introduction of such testimony. (R. 113, 131, 133, 138)

With respect to each of these instances taxpayer made an offer of proof. (R. 114-120, 132, 133, 138) In each instance the offer of proof supported the showing that taxpayer had attempted to make. (R. 120-121, 132, 133, 138)

3.7. Commissioner's Determination

In his notice of deficiency, the Commissioner determined that for the taxable year 1967 taxpayer's gross income should have included "assessments" in the amount of $38,925 and that for the taxable year 1968 taxpayer's gross income should have included "assessments" in the amount of $38,355. (R. 11, 190) The Commissioner also determined that a penalty of $463.05 was due pursuant to section 6651 on account of taxpayer's failure to file a timely return for the taxable year 1967. (R. 11, 190)

3.8. Post-Trial Proceedings

On February 6, 1975, the Tax Court filed its memorandum findings of fact and opinion and determined that the "Decision will be entered under Rule 155." (R. 153-206)

Understanding the Tax Court's decision to mean that a computation under Rule 155 was necessary because taxpayer did not properly earmark amounts taken in as assessments so as to qualify such amounts as capital contributions on that basis, taxpayer submitted its computation for entry of decision using the allocation formula approved in Bear Valley Mutual Water Company v. Riddell, 283 F.Supp. 949 (C.D. Calif.

1968), affirmed per curiam, 427 F.2d 713 (9th Cir. 1970). (R. 209-214) Under the Bear Valley case the allocation between capital contributions and gross income is made in accordance with the following formula: (R. 210)

$$\frac{\text{Member Assessments}}{\text{Member Assessments + Net Income}} \times \text{Capital Expenditures} = \text{Amount to be Excluded from Gross Income}$$

Taxpayer's calculations showed that this formula would have resulted in no deficiency for the taxable year 1967. (R. 211) By reason of this computation taxpayer concluded that there would be no addition to tax for the taxable year 1967 since the addition to tax under 6651 is a percentage of the deficiency determined to be due. (R. 211) For the taxable year 1968, taxpayer's calculations under the Bear Valley formula resulted in a deficiency of $3,119.79. (R. 212)

The Tax Court rejected taxpayer's computation under Tax Court Rule 155 and accepted the Commissioner's computation. (R 215) The Commissioner's computation under Tax Court Rule 155 was a mere restatement of the original determination of deficiency as stated in the statutory notice of deficiency originally mailed to taxpayer. (R. 207-208)

4. Summary of Argument

Under section 118, a contribution to the capital of a corporation is excludable from gross income. In the present case taxpayer is a corporation and its members are in the

nature of shareholders with respect to taxpayer. Section 7701 (a)(8).

As applied to this case, the question to be determined is whether the amounts paid by taxpayer's members to taxpayer in respect of assessments were direct payments for specific, quantifiable services provided for the members by taxpayer. United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (1973). If the benefits expected by the members were indirect, general, or speculative, the payments would be considered contributions to capital rather than gross income.

In the context of membership organizations, three basic theories are available to determine the line between contributions to capital and gross income, namely, the "earmarking", "expenditures", and "allocation" theories. Under the earmarking theory, amounts paid by members to a membership organization may be excluded as contributions to capital to the extent that they have been specifically earmarked for particular capital purposes. Minnequa University Club, 30 T.C.M. 1305 (1971). Under the expenditures theory, payments by members may be excluded from income to the extent that they do not exceed the amount of capital expenditures made by their membership organization. Lake Petersburg Association, 33 T.C.M. 259 (1974). Under the allocation theory, a membership organization may exclude from its gross income as a contribution to capital

an amount that bears the same proportion to its capital expenditures as its member assessment income bears to the total of member assessment income plus nonmember net income. Bear Valley Mutual Water Company v. Riddell, 283 F. Supp. 949 (C.D. Calif. 1968), affirmed per curiam, 427 F.2d 713 (9th Cir. 1970). Taxpayer here qualifies under each of these theories.

Under a long line of cases dealing with payments by tenant-stockholders to cooperative housing corporations, the accounting standard to be employed in determining whether assessments have been properly set aside for capital purposes is a rule of reason looking to the substance and not to the technical form of the manner of segregation. Further, taxpayer's board of directors was under a fiduciary obligation to apply moneys received as assessments for capital purposes.

In the present case the Tax Court made the following errors:

(a) The Tax Court failed to apply the applicable law.

(b) The Tax Court found facts that were not supported by the record.

(c) Specifically, the Tax Court contradicted a material factual stipulation of the parties.

(d) The Tax Court refused to permit the introduction of testimony tending to show the intent of taxpayer's members as to the nature of amounts they paid as assessments.

5. Argument

THE TAX COURT ERRED IN FINDING AND RELYING UPON FACTS THAT EITHER (A) DID NOT EXIST, WERE CLEARLY CONTRARY TO THE STIPULATION OF THE PARTIES AND THE RECORD IN THIS CASE, OR WERE INCONSISTENT WITH THE TAX COURT'S OWN FINDINGS, OR (B) WHEN JUXTAPOSED WITH THE APPLICABLE LAW, REQUIRED A DECISION IN FAVOR OR TAXPAYER.

The Tax Court ignored the applicable law and instead substituted its own mistaken views, in each instance without reference to any authority, of the principles governing the determination of the primary issue in this case. In addition, the Tax Court so distorted the facts that its findings of fact contradicted not only the stipulation of the parties and the clear conclusions that should have been drawn from the record, but were also inconsistent with each other. In the following discussion taxpayer will discuss the applicable law and will show that the facts found and relied upon by the Tax Court either (a) did not exist, were clearly contrary to the stipulation of the parties and the record in this case, or were inconsistent with the Tax Court's own findings, or (b) when juxtaposed with the applicable law, required a decision in favor of taxpayer.

5.1. The Applicable Law

5.1.1. Statutory Basis

Under section 118, a contribution to the capital of a corporation is not includible in gross income for Federal income tax purposes. The term contribution to capital is nowhere defined in the statute, and the income tax regulations under section 118 do not provide much illumination

on the subject. Treas. Reg. § 1.118-1. It should be noted that section 118 was enacted in 1954 primarily to clarify the law with respect to nonshareholder contributions. H. Rept. No. 1337, 83rd Cong., 2d Sess., p. 17 (1954).

An initial determination that must be made is whether taxpayer here was a "corporation" so as to be entitled to exclude income under section 118. Certainly in form taxpayer was a corporation having been incorporated under the New York Membership Corporations Law which was repealed shortly after the years here in issue. Notwithstanding taxpayer's corporate form, at trial and on brief the Commissioner seemed to be arguing that section 118 was not applicable because taxpayer's members were not in the nature of shareholders. This argument must fail on two grounds. First, it is not necessary that a transfer of property to a corporation be made by a shareholder before such a transfer can qualify as a contribution to capital. E.g., United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973). Second, members of a nonstock corporation are in the nature of stockholders where, among other things, the members are entitled to the assets of their nonstock organization upon liquidation. E.g., Minnequa University Club, 30 T.C.M. 1305 (1971). Here, taxpayer's regular members were deemed owners of taxpayer and would have received its assets on dissolution

and liquidation. Indeed, under section 7701(a)(8), it is clear that taxpayer's members are considered shareholders for purposes of the Internal Revenue Code. Under section 7701(a)(8) there is no absolute requirement that a shareholder own shares; being a member of an association is sufficient.

5.1.2. Supreme Court Cases

Since the enactment of the Sixteenth Amendment, the Supreme Court has dealt specifically with the question of what constitutes a contribution to capital at least four times. United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973); Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950); Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943); and Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925). These cases dealt with nonshareholder contributions to capital and for that reason are not completely analogous to the situation here where the payments in question were from taxpayer's members, who, for all intents and purposes, were taxpayer's shareholders.

In United States v. Chicago, Burlington & Quincy Railroad Co., supra at 413, the Supreme Court found that there were five characteristics of contributions to capital implicit in its prior decisions in the area, namely:

> (a) A contribution to capital "certainly must become a part of the transferee's working capital structure."
>
> (b) The contribution to capital "may not be compensation, such as direct payment for a specific, quantifiable service provided for the transferor by the transferee."

(c) The contribution to capital "must be bargained for."

(d) "The asset transferred forseeably may result in benefit to the transferee in an amount commensurate with its value."

(e) "And the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect."

To the extent applicable to shareholder contributions, each of these characteristics exists in this case.

Initially, the fact that the payments by the members were essentially money eliminates need for further discussion with respect to the first, fourth, and fifth characteristics listed above. Thus, by its very nature a payment of money immediately upon payment would become a part of taxpayer's working capital structure. Also, the member's money payments would benefit taxpayer in an amount exactly equal to their value. Finally, as money is a fungible item, its payment to taxpayer will necessarily lessen the need for the production of additional income so as to contribute to the production of additional income. And, the value of money is generally assured subject only to the eroding effects of inflation.

As to the second characteristic, in the context of a member-club relationship, the payments by a member with respect of dues, assessments, or other payments were governed by the terms of taxpayer's constitution and bylaws which constituted the contract between taxpayer and its members.

Since taxpayer and its members could modify that contract by interaction at annual meetings, the assessment payments must be assumed to have been "bargained for."

As applied to taxpayer, then, the Supreme Court's test boils down to whether the payments in issue were direct payments "for a specific, quantifiable service provided for the transferor by the transferee". United States v. Chicago, Burlington & Quincy Railroad Co., supra at 413. If the benefits expected were indirect, general, or speculative, the payment would be considered a contribution to capital rather than gross income. In the context of this case, this basic test requires a differentiation between consideration for goods and services and a mere enhancement of the value of the members' membership rights. It was in this basic context that both taxpayer and the Commissioner argued this case in the Tax Court below. Unfortunately, the Tax Court drifted off into a discussion of various irrelevant matters not argued by the parties including, in particular, the effect of the repeal of an excise tax.

One point that should be made is that to qualify as a contribution to capital a payment by a member to taxpayer did not have to be "voluntary" in the sense of being purely gratuitous. Indeed, the Supreme Court requirement that a contribution to capital must be "bargained for" seems to indicate that, at least in the case of nonshareholder contributions, it would be a rare contribution to capital

that would be voluntary in this sense. It is true that the Treasury Regulations under section 118 give an example of a corporation obtaining additional funds through "voluntary" pro rata payments by its shareholders and that such payments did not constitute gross income to the corporation. Treas. Reg. § 1.118-1. In addition, one of the Commissioner's old rulings seems to view the voluntariness of payments as a factor in determining whether the payments constituted contributions to capital. I.T. 1469, I-2 C.B. 191 (1922). But aside from the point that neither of these examples provides any interpretation of the term "voluntary", the fact that in two examples voluntary payments by shareholders to their corporations qualified as contributions to capital does not require the conclusion that all contributions to capital must be voluntary.

5.1.3. Specific Theories

At least three specific theories have evolved in the judicial quest for guidelines to help to determine whether amounts paid by members to membership organizations can qualify as contributions to capital. For convenience these theories will be called the "earmarking", "expenditures", and "allocation" theories. While there may be some discrepancy among the courts whether all three of these theories are valid, taxpayer submits that it has satisfied the requirements of each theory so as to qualify the payments in question here as contributions to capital.

Under the earmarking theory amounts paid by members to a membership organization may be excluded as contributions to capital to the extent that they have been specifically earmarked for particular capital purposes.

The earmarking theory is probably best exemplified in Minnequa University Club, 30 T.C.M. 1305 (1971). In that case a social club decided to finance various items of repair, enlargement, and improvement by levying special assessments on its members. Members were permitted to pay the assessments through increases in monthly dues over a period of five years. The funds generated by the assessments were place in a segregated bank account and treated separately on the club's books. "In short, they were earmarked for capital improvements from the time they were assessed until they were actually used for payment of construction costs." 30 T.C.M. at 1309. The Tax Court indicated that at least four factors of earmarking supported its decision that the funds derived from the special assessments constituted contributions to the capital of the club. The Tax Court summed up these factors as follows:

> That the assessed amounts were received by petitioner as contributions to its capital is clear. The terms of the assessment limited the use to be made of the funds. The funds were always maintained and accounted for separately; and, lastly, the funds were actually expended on capital expenditures. We therefore can only conclude that they were capital contributions. [30 T.C.M. at 1310]

The record here indicated that each of these four factors were present. First, the record as a whole indicated that taxpayer's board of directors, officers, and members understood that amounts listed on the dues structures as assessments were being set aside for capital improvements and were therefore received as contributions to its capital. As evidence of this fact were (a) taxpayer's long-established policy of levying assessments for capital purposes, (b) information in taxpayer's annual meeting notices that amounts were being set aside for capital improvements (R. 21; Ex. Vol. 79, 81, 83, 85 - 87), (c) the pattern by which taxpayer distributed dues structures at the beginning of each of its taxable years (except 1968) clearly segregating dues from assessments, (d) discussion of the dues structures among the members, and (e) involvement of the members in the capital improvements program. Second, the terms of taxpayer's assessments limited the use to be made of these funds. In other words, if taxpayer's board of directors decided to use the funds for some purpose other than what had originally been intended, it would presumably have been held answerable to the members for its misappropriations. Third, the funds were accounted for separately on taxpayer's books during the years in question, and a separate bank account was established in anticipation of the making of a down payment for the purchase of the property used by taxpayer. Finally, the funds collected as assessments were actually expended

on capital expenditures. Specifically, the funds in the separate savings account were actually used for the down payment for the purchase of the property used by taxpayer.

Under the expenditures theory, payments by members may be excluded from income as capital contributions to the extent that they do not exceed the amount of capital expenditures made by the corporation.

The expenditures theory is probably best exemplified by the case of Lake Petersburg Association, 33 T.C.M. 259 (1974). In that case the taxpayer informed applicants for membership that assessments would be made and accumulated for the purchase of land and the erection of various improvements on the land. The record in the case established that the taxpayer had collected assessments totaling $850,000 whereas actual capital expenditures amounted to only $810,000. The Tax Court found that the taxpayer had adequately explained why the excess sums had not been spent for capital items. In addition, the Tax Court stated that, "the petitioner did not intentionally collect assessments in excess of its capital needs", thus implying that so long as assessments did not exceed capital needs they would be excludable from income as capital contributions. 33 T.C.M. at 267.

While the Tax Court in Lake Petersburg justifies its decision by concluding that "petitioner adequately earmarked the assessments to be used for capital purposes", the decision really supports a broader conclusion. Id. The Lake Petersburg case indicates that where amounts are paid in by

members and excluded as contributions to capital by the membership organization, the amounts will in fact be considered excludable from gross income provided that they do not exceed capital expenditures or needs. It is significant to note that the Commissioner himself has approved the Lake Petersburg case in one of his recent published rulings. Rev. Rul. 74-563, 1974-2 C.B. 38.

Here, the entire amount of assessments received by taxpayer during each of the years in issue qualifies for capital-contribution treatment under the expenditures theory since capital expenditures clearly exceeded assessments for each year in issue.

The allocation theory would appear to establish a synthesis of the earmarking and expenditures theories. Under the allocation theory there is a recognition that, in computing the tax liability of a nonexempt organization which conducts activities from which it derives income in addition to its basically nonprofit member activities, the income and expenses attributable to its nonmember activities should somehow be isolated from the income and expenses related to its member activities. The Tax Court below seemed to recognize the viability of such a theory when it stated:

> The deposit of funds in a savings account, shown on the balance sheet as being maintained for the purchase of the club property, does not of itself give rise to a capital contribution within the meaning of section 118. It would be equally consistent to assume that the amounts thus set aside represented a portion of the net income and cash flow from depreciation. [R. 197]

This theory is best seen in its practical application in the case of Bear Valley Mutual Water Company v. Riddell, 283 F. Supp. 949 (C.D. Calif. 1968), affirmed per curiam, 427 F.2d 713 (9th Cir. 1970). Specifically, the allocation theory provides that a membership organization like taxpayer should be entitled to exclude from its gross income as a capital contribution an amount that bears the same proportion to its capital expenditures as its member assessment income bears to the total of member assessment income plus nonmember net income.

Taxpayer attempted to use the formula generated by the Bear Valley case in its Rule 155 computation in the Tax Court below. However, in summary fashion the Tax Court rejected taxpayer's computation. (R. 215)

5.1.4. Cooperative Housing Corporation Cases

Very closely analogous to this case are the factual patterns in a long line of cases dealing with cooperative housing corporations. Typically, tenant-stockholders of cooperative housing corporations make periodic payments to cover such items as mortgage principal, mortgage interest, and general maintenance expenses. The mortgage principal would be analogous to the amounts payable by taxpayer here for the purchase of its premises, while payments made for interest and maintenance expenses would be analogous to taxpayer's everyday operating expenses.

The proposition that amounts paid in respect of mortgage principal should be excludable from gross income as contributions to capital was firmly established as early as 1922 in I.T. 1469, I-2 C.B. 191 (1922). Cf. Paducah & Illinois Railroad Co., 2 B.T.A. 1001 (1925).

In 874 Park Avenue Corporation 23 B.T.A. 400 (1931), the tenant-stockholders of a cooperative apartment paid amounts to be used for amortizing the apartment's underlying mortgage. These assessments were separately entered on the taxpayer's books under the heading "assessments", but were not separately reflected in a "paid-in surplus" account. The Board of Tax Appeals nevertheless permitted the assessments to be treated as contributions to capital and hence excludable from gross income on the basis that there had been "substantial compliance" with the requirement that the assessments be credited to a separate paid-in-surplus account. 23 B.T.A. at 407 .

The taxpayer's board of directors in Cambridge Apartment Building Corporation, 44 B.T.A. 617 (1941), had, until 1935, listed information with respect to assessments in the annual budget. In 1935 the budget was discontinued but assessments for 1936 and subsequent years continued to be made on the basis of prior years' assessments. The Commissioner argued that since the tenant-stockholders had not been informed of

the assessments in the years in issue, there could not have been an "understanding" of the type necessary to sustain the finding that the assessments were capital contributions. Adopting a rule of reason, the Board rebuffed the Commissioner in the following manner:

> Counsel for the respondent attempts to distinguish the latter case [874 Park Avenue Corporation, supra] on the ground that there was an understanding in that case prior to the time the assessments were made that they would be used to retire indebtedness, whereas here, he says, there was no such agreement. The cases are not distinguishable on this basis. The stockholders in the present case had an understanding in prior years, as indicated by budgets, that a part of the assessments would be used to retire indebtedness. Although the budget was abandoned after the reorganization under section 77B, nevertheless, the plan of reorganization approved by the court expressly provided that all amounts collected by assessment which were not needed to defray operating expenses would be used to retire bonds. The amounts here in question were collected by assessment pursuant to this order of the court and were used to retire bonds. Therefore, following the above cited cases, we hold on this point for the petitioner. [44 B.T.A. at 618-619]

In the recent case of Eckstein v. United States, 452 F.2d 1036 (Ct. Cl. 1971), the Court of Claims rejected in similar fashion an overly technical argument based upon the manner in which assessments by an apartment cooperative were kept in the same bank account with income-oriented receipts. The Court of Claims pointed out that the "substance" of the whole transaction was determinative, "not the bank account mechanics the cooperative employed." 452 F.2d at 1044. In determining that the cooperative had adequately separated the portion of the assessments intended to be contributions to

capital, the Court of Claims considered important the facts that the cooperative's accounting statements had made a clear separation of such amounts and that the intention of the cooperative was that only the assessments would constitute the source of mortgage principal installments due. See also United States v. Akin, 248 F.2d 742 (10th Cir. 1957), certiorari denied, 355 U.S. 956 (1958).

It is significant to note that in the cooperative housing corporation cases the courts have adopted a rule of reason as respects the accounting standard that must be applied to permit treatment of assessments as contributions to capital. In other words, the courts speak of "substantial compliance" and "the understanding" of the tenant-stockholders over the years, and not the "bank account mechanics" or specific contractual agreements as to the nature of assessments. These cases also point out that a separate fund is not necessary to establish a capital contribution; a separate accounting in the annual budget will suffice.

The facts in the instant case clearly fall within the parameters of this rule of reason. As already noted, taxpayer's members received notice of the fact that assessments were accounted for separately. Further, taxpayer had established a clear pattern of listing assessments separately on the dues structure. Perhaps most significant is the fact that assessments were separately listed on taxpayer's financial

statements appearing in its annual meeting notices that went out to all its members. (Ex. Vol. 79, 81, 83, 85 - 87)

5.1.5. Fiduciary Obligation of Taxpayer's Board

It should be noted that even if taxpayer's Board of Directors had spent amounts collected as assessments from taxpayer's members for other than capital purposes, a misappropriation of this type would not have required a conclusion that the amounts collected as assessments should have been included in taxpayer's gross income.

Under the principles of such cases as Ford Dealers Advertising Fund, Inc., 55 T.C. 761, 772-774 (1971), affirmed, 456 F.2d 255 (5th Cir. 1972), N.Y. State Assn. Real Est. Bd. Group Ins. Fund, 54 T.C. 1325, 1334-1336 (1970), Dri-Power Distributors Association Trust, 54 T.C. 460, 479 (1970), and Seven-Up Co., 14 T.C. 965 (1950), taxpayer held amounts collected as assessments and listed on its financial statements as assessments for the benefit of its members. It had a fiduciary obligation to apply such amounts for the purposes for which they had been collected, namely, capital purposes.

5.1.6. The United Grocers Case

The Commissioner has relied primarily on United Grocers, Ltd. v. United States, 308 F.2d 634 (9th Cir. 1962). That case is easily distinguishable from the instant case.

In the United Grocers case the taxpayer was a wholesale grocery cooperative which sold merchandise to both members and nonmembers but which distributed patronage dividends only to members. In 1952 the taxpayer discontinued accounting for payments from members as dues and included all monthly payments from members in a capital contributions account. The Ninth Circuit found that:

> . . . the dominant purpose for members was to obtain merchandise and services at the lowest possible prices. While members and nonmembers were billed for the same amount the members in effect received reduced prices through the patronage dividends. Each member was a retail grocer who, as a practical matter, was not interested in an investment or the well-being of appellant, except as an incident to his need to purchase groceries at advantageous and competitive prices. It is reasonable to assume that a member would continue to pay the fees and monthly assessments only so long as the total amount paid remained less than the cost of similar merchandise and services elsewhere. As was said in Detroit Edison, supra, "The payments were to the [member] the price of the service." [308 F.2d at 639-640]

In the instant case it is clear that taxpayer's members were concerned with taxpayer's well-being as reflected by the social nature of taxpayer's operations. Members were approved after lengthy personal interviews so that they would fit into the social framework of taxpayer and benefit taxpayer as much as taxpayer would benefit them. By paying assessments, taxpayer's members were investing in the future of taxpayer. The nature of this investment was capital in nature, not a payment for goods and services to be rendered.

It is important to appreciate the difference between the social nature of taxpayer's operations and the commercial nature of the operations involved in the United Grocers case. Taxpayer's operations involved basically a pooling of member resources for mutual member benefit. Indeed, it has been stipulated that taxpayer was operated primarily as a social club for the benefit of its members. To the contrary, the commercial operations in the United Grocers case were aimed primarily at providing goods and services at a profit.

It is true that the Commissioner revoked taxpayer's Federal income tax exemption under section 501(c)(7). However, taxpayer did not by such action become a profit-making venture. Taxpayer has not abandoned its social function. This fact is an important factor in determining whether the amounts paid by taxpayer's members as assessments should be considered as contributions to capital or as payments for goods and services because it indicates that a member would not have taken his social "business" to some other lower-priced club as would have been the case in the cold economic factual context of the United Grocers case.

Finally, such cases as James Hotel Company v. Commissioner, 325 F.2d 280 (10th Cir. 1963), and, more recently, The University Country Club, Inc., 64 T.C. No. 45, CCH Tax Ct. Rep., Dec. 33,277 (June 23, 1975), are not controlling here because the payments in

question in each of those cases were in respect of a non-proprietary class of stock. In the instant case there is no question that taxpayer's members had a proprietary interest in taxpayer. Taxpayer had no investor class of stock upon which taxpayer's assets could devolve in the event of taxpayer's liquidation.

5.2. The Tax Court's Opinion

Taxpayer frankly admits that it is unable to ascertain the precise ratio decidendi of the Tax Court's opinion below. The Tax Court's opinion lists factor after factor that are said to support its ultimate holding that the Commissioner's initial determination of deficiency was correct. But, between that list of factors and the ultimate holding there does not appear to be any manner of unifying logical theme.

The following paragraph-by-paragraph analysis of the Tax Court's opinion will show that the Tax Court's view of the basic principles involved in this case was erroneous. In addition, the analysis will show how the Tax Court distorted the facts to the point where it actually contradicted the stipulation of the parties.

5.2.1. The Tax Court's Discussion of the Provisions of Repealed Sections 4241 and 4243(b) was Completely Irrelevant to the Issue at Hand.

After setting forth a brief background of the case and an outline of taxpayer's position, the Tax Court quoted from section 118 and analogized to section 118 the provisions of repealed section 4241. (R. 190-191) Indeed, the Tax Court dealt at length with the excise tax under repealed section 4241 and its relation to the issue in this case. (R. 156-160, 191)

Taxpayer fails to see the significance of these references. Whether taxpayer initiated a procedure of including assessments in its dues structures in order that a corresponding amount expended on capital improvements could be relied upon to provide an exemption from the excise tax or whether the procedures followed by taxpayer were sufficient to entitle it to the exemption under repealed section 4243(b) were, as is partly conceded by the Tax Court, irrelevant to the decision of the issue before it in this case. (R. 191, fn. 13) It is also irrelevant whether the applicability of repealed section 4243(b) is not limited to "capital contributions" within the scope of section 118. (R. 191, fn. 13)

None of these issues were argued by either party and none of them bear on the question of whether the assessments, whether or not they qualified under repealed section 4243(b), were capital contributions within the scope of section 118.

Section 118 relates to the operation of the Federal income tax, a tax that is levied under Chapter 1 of the Internal Revenue Code and acts independently of the excise taxes, whether repealed or in force, found in Chapter 33 of the Internal Revenue Code.

It is interesting to note that the Tax Court stated that "the applicability of sec. 4243(b) is not limited to 'capital contributions' within the scope of sec. 118." (R. 191, fn. 13) Taxpayer would suggest that to present a balanced picture the Tax Court should also have stated that, conversely the applicability of section 118 is not limited to amounts which would qualify for the exemption under repealed section 4243(b). In other words, a payment to a corporation does not have to qualify for the exemption under repealed section 4243(b) to qualify also as a capital contribution under section 118.

5.2.2. The Tax Court Completely Ignored Any Analysis of the Applicable Law.

The Tax Court proceeded to quote from the language of the report of the House Committee on Ways and Means dealing with the enactment of section 118 and set out in its entirety the language of Treas. Reg. § 1.118-1, without commenting as to the applicability of those items to the case at hand. (R. 192-194) In similar summary fashion the Tax Court listed the cases relied upon by taxpayer and the Commissioner and concluded that:

> The fallacy of the petitioner's reasoning stems not from the law in these cases but from the misconception in petitioner's brief of the facts. [R. 194]

From this point on in the Tax Court's opinion no cases are cited and no reliance is placed on any authority other than the Tax Court's own summary statements of what it believed constituted the essential requirements to permit qualification of receipts of a corporation as contributions to capital. As will be shown, the Tax Court's view of what these essentials were was incorrect. Indeed, taxpayer will also show that in many instances the factors relied upon by the Tax Court for a finding that the assessments levied by taxpayer were not contributions to taxpayer's capital were actually relied upon in the cases cited by taxpayer to support findings that receipts should have been considered contributions to capital.

This is not a case of first impression and should not have been decided by the Tax Court in a vacuum. The factual situations presented in Minnequa University Club, supra, Lake Petersburg Association, supra, and the other cases upon which taxpayer relied were closely analogous to the facts in this case. If they were not, the Tax Court should have pointed out the distinctions. Instead the Tax Court completely ignored taxpayer's carefully reasoned arguments showing the close relation of the cases cited to the factual situation at hand. Nor did the Tax Court attempt to show

why the facts in this case should have been governed by the cases cited by the Commissioner so as to support the Commissioner's determination.

From the Tax Court's findings of fact and memorandum opinion taxpayer cannot determine which findings of fact support the Tax Court's ultimate conclusion. The rambling nature of the Tax Court's opinion and the Tax Court's failure to connect its findings of fact into any cohesive statement of the principles involved in this case make it impossible for anyone, much less taxpayer, to know upon what basis the Tax Court denied taxpayer's request for a redetermination of deficiency. Surely due process demands a better explanation than the one that the court of record below has purportedly given.

5.2.3. The Tax Court's Discussion of the Amounts Representing Savings in the Excise Tax at Most Related to the Question of Earmarking and Should Not Require that No Amounts Received by Taxpayer Be Excluded from Gross Income.

The Tax Court seemed to draw a close connection between the so-called "savings" realized from the repeal of the excise tax under section 4241 and the amounts deposited in the Schenectady Savings Bank. (R. 195-197)

Taxpayer submits that the amounts deposited in the savings account were directly related to the credits to the "No. 501

Assessments" account as supported by the testimony of taxpayer's long-time bookkeeper. (R. 66-67) The fact that the deposits in the savings account did not exactly equal the credits in the 501 account may be explained on the basis that upon establishment of the savings account there may have been some confusion at the lower levels of taxpayer's accounting department as to the exact manner in which deposits to the savings account should have been computed. By the beginning of the taxable year 1969, credits to the 501 account exactly corresponded to deposits in the savings account. The inference may be drawn that by that time taxpayer's accounting department had straightened out the confusion involved. In any event, the differences between the amounts credited to the 501 account and the amounts actually deposited in the savings account were relatively small.

The Tax Court expected a degree of accounting accuracy that would have placed an unwarranted burden on a social organization like taxpayer. As taxpayer suggested to the Tax Court below, taxpayer's books and records were those of a family-oriented social and recreational organization and not those of a "Fortune 500" company. The Tax Court's tracing of excise tax savings to a savings account was ill-advised. What was important was not the "bank account mechanics" employed in setting aside amounts for capital purposes, but the substance of the manner in which taxpayer received payments from its members. _Eckstein v. United States_, _supra_.

Whether or not the members were informed by taxpayer's board of directors that any portion of the savings resulting from the repeal of the excise tax would be set aside or earmarked as a contribution to capital is beside the point. The record overwhelmingly indicated, at the very least, that taxpayer continually informed its members that some amounts were being set aside for capital improvements and that these amounts bore a direct relation to the amounts denominated as assessments on taxpayer's dues structure. This latter fact having been shown it would have been appropriate for the Tax Court to require a computation of at least a certain minimum amount that would qualify as a contribution to taxpayer's capital. See Berenson v. Commissioner, 507 F.2d 262, 269 (2d Cir. 1974), affirming, reversing, and remanding, 59 T.C. 412 (1972).

In this respect the Tax Court's statement that the deposit of funds in a savings account maintained for the purchase of the real property used by taxpayer "does not of itself give rise to a capital contribution within the meaning of section 118" was quite misleading. (R. 197) As the record showed this factor was one of the less significant of several factors showing that taxpayer was receiving amounts as contributions to its capital. See pp. 9-12, supra. In other words, this factor did not exist "of itself" as the Tax Court would have a casual reader of its opinion believe.

At most the Tax Court's remarks at this point in its opinion merely suggested that there may not have been proper earmarking of the amounts taxpayer received as assessments. Indeed the Tax Court itself stated:

> It would be equally consistent to assume that the amounts thus set aside represented a portion of the net income and cash flow from depreciation. [R. 197]

This statement described precisely the assumption made in the Bear Valley case. The Court in Bear Valley found that there had not been proper earmarking as capital contributions of amounts taken in from members. Thus, the court in Bear Valley made the perfectly reasonable assumption that amounts set aside for capital improvements were derived not only from assessments from members, but also from nonmember net income. The Tax Court, with hardly a word of explanation, refused to adopt taxpayer's requested Rule 155 computation, thus ignoring its own reasoning. Cf. Sirbo Holdings, Inc. v. Commissioner, 476 F.2d 981, 987 (2d Cir. 1973).

5.2.4. The Tax Court's Understanding of the "Essential Elements" for the Existence of a Capital Contribution was Erroneous.

The Tax Court made a fundamental assumption for which it cited no authority and for which no authority exists. It stated that if the deposits in the savings account were

looked to as a basis for the exclusion from income, "the essential elements of notice and assent to the contribution are lacking". (R. 198)

Taxpayer submits that neither the element of notice nor the element of assent is an absolute prerequisite for a finding that there has been a contribution to capital within the meaning of section 118.

One of the Commissioner's own rulings indicates that assent is not necessary. Rev. Rul. 74-563, 1974-2 C.B. 38. In that ruling an unpaid assessment, payment of which qualified as a contribution to capital, would have constituted a lien on the property of a homeowner-member of a homeowners' association. Such a consequence is hardly in keeping with the notion of voluntariness that is implicit in the word "assent". Further, the fact that an <u>example</u> in Treas. Reg. §. 1.118-1 refers to a corporation's acquisition of additional funds through "voluntary pro rata payments by its shareholders" does not mean that all contributions to capital need be voluntary. The cooperative housing corporation cases are further support for this position.

Nor is the element of notice as essential as the Tax Court matter-of-factly states. Certainly no notice is required in the simple case where a shareholder contributes money to his corporation and receives nothing in return. He does not need any notice because he already knows that since he has obtained in return no goods, services, or other consideration, other than a possible increase in the inherent

value of his stock, the amount is a contribution to capital. Indeed, there are even transactions where a contribution to capital is deemed to be made under circumstances where a shareholder has no idea that he has made a contribution to capital until the Internal Revenue Service, and not the corporation, informs him of the fact. See J.F. Stevenhagen Co., 34 T.C.M. 852, 858-859 (1975); Rev. Rul. 69-630, 1969-2 C.B. 112; see also section 304(a)(1).

But, even accepting the Tax Court's view that notice is "essential", the record indicates that taxpayer's members were notified in numerous ways that payments they were making were contributions to capital. See pp. 9-12, supra. Indeed, the Tax Court elevated many of the bits of evidence showing that the members had received notice to specific findings of fact. (R. 164-165, 167-169, 171, 173-174, 182-184, 186-187) Yet, notwithstanding its own findings to the contrary, the Tax Court concluded that taxpayer's members received no notice relating to contributions to capital.

Tax Court then looked separately to the "No. 501 Assessment account as a basis for the contribution to capital and found the "essentials" for such a contribution "likewise" lacking. (R. 198) The Tax Court stated that this account was set up for the purpose of segregating a portion of the

dues to be expended for capital improvements in order to minimize the impact of the excise tax on dues. (R. 198)

As has just been discussed, the Tax Court was mistaken in its understanding of what constituted the "essentials" necessary for a payment to a corporation to be considered a contribution to capital. Similarly, whether or not the account was originally established for the purpose of segregating a portion of dues to be expended for capital improvements in order to minimize the impact of the excise tax on dues was irrelevant. The Tax Court was again confusing excise tax notions with notions of what constituted a contribution to capital under section 118. In so doing the Tax Court effectively found that taxpayer was in fact segregating assessments from other receipts and holding those assessments for the purpose of capital improvements.

5.2.5. <u>The Tax Court Confused the Factors Necessary for the Existence of Earmarking with the Factors Necessary for the Existence of a Capital Contribution</u>.

The Tax Court noted that for the taxable year 1965 taxpayer's president submitted a report indicating that initiation fees and assessments would be applied to both capital and noncapital expenditures. (R. 199) The Tax Court thus implied that the use of such language should be considered to override the many other specific factors showing that assessments were closely related to amounts set aside for capital purposes.

The president's letter did not state that assessments were in fact used for noncapital purposes. Certainly there can be no formal requirement under the Federal income tax law that every time taxpayer mentioned the term "assessments" it should also have made simultaneous mention of the capital purposes for which the assessments were intended. There must be some point at which, after long and continued use, a word takes on a common and accepted meaning.

A similar analysis applies to the president's letter of March 9, 1967, describing proposed expenses for the coming year. (R. 199-200) While the letter did not specifically designate what portion of the amounts to be collected would be dedicated to the purposes described therein, it seems clear that after a long-existing history where dues and assessments were continually listed separately on the taxpayer's dues structure, it could be assumed that the members would expect assessments to be applied to capital improvements and that dues would be applied to operating expenses. Cambridge Apartment Building Corporation, supra. Even if a failure of taxpayer to be specific each and every time it referred to assessments meant that earmarking of those assessments for capital purposes did not exist, the failure of earmarking did not require the conclusion that none of the amounts taken in as assessments constituted contributions to capital under section 118. Failure to earmark may have raised

a question as to whether payments for capital purposes arose from an assessments fund, from net income, or from a cash flow created by depreciation as the Tax Court suggested (R. 197), but such a question brings into play the Bear Valley case. Such a question goes merely to the extent to which the assessments should have been included in income and does not require inclusion of the entire amount of such assessments in income.

The Tax Court made an additional point that the amount designated at "assessments" was included on taxpayer's books and records in income in determining profit and loss. (R. 199)

Taxpayer fails to see the significance of this point. Indeed, at trial the Tax Court itself failed to see the significance of this point when it was raised by the Commissioner. (R. 79-80) Taxpayer is at a loss to explain why the Tax Court has changed its mind, and the Tax Court gives the reader of its opinion no reason why this fact should be considered significant. Cf. Handelman v. Commissioner, 509 F.2d 1067, 1073 n.8 (2d Cir. 1975). Contrary to any implication of the Tax Court, profit and loss for book purposes is not gross income and deductions for tax purposes. Patchen v. Commissioner, 258 F.2d 544, 549-550 (5th Cir. 1958), reversing, 27 T.C. 592, 598 (1956) (both Court of

Appeals and Tax Court recognizing that net income on books need not correspond exactly with taxable income on return since adjustments are frequently required to reconcile book and taxable income].

5.2.6. <u>The Tax Court Committed Reversible Error by Finding Contrary to the Stipulation of the Parties</u>.

Taxpayer and the Commissioner specifically stipulated that announcements of taxpayer's annual meetings for the taxable years in issue as well as years immediately before and after the taxable years in issue were sent to taxpayer's members. (R. 21) On each of these annual meeting notices was listed taxpayer's financial statements which consisted of both a balance sheet and an operating statement. (Ex. Vol. 79, 81, 83, 85-87) In each of the years in issue the operating statement clearly separated amounts received as dues from amounts received as initiation fees and assessments. (Ex. Vol. 81, 83) In each of the years in issue the asset side of the balance sheet listed as an account a special cash fund. (Ex. Vol. 81, 83) Furthermore, similar listings existed on the balance sheets and operating statements that were a part of the annual meeting notices for each of the taxable years 1966, 1969, and 1970. (Ex. Vol. 79, 85-87) It is clear from this stipulation alone that the "essential" notice contemplated by the Tax Court did exist.

Notwithstanding this stipulated fact the Tax Court stated:

> Petitioner's brief is incorrect in that it states that "the amount [sic] set aside as assessments were separately listed on the financial statements that appeared in petitioner's annual meeting notices which went out to all of petitioner's members". The practice of setting forth the assessments separately was discontinued with the repeal of the excise tax and the adoption of the new dues structure effective April 1, 1967. [R. 200]

The Tax Court contradicted a material stipulated fact, considered that contradiction a material fact, and relied on the contradiction in applying its version of the law to obtain a result adverse to taxpayer.

Under its own Rule 91(e) the Tax Court was bound to treat the parties' stipulation as a conclusive admission by the parties and could not permit any modification or contradiction of the stipulation except "where justice requires". Clearly justice did not require the contradiction effected by the Tax Court. If nothing else the Tax Court's clear disregard of the parties' stipulation highlights in one paragraph the cavalier manner in which the Tax Court has treated both taxpayer's legal arguments and factual presentations.

5.2.7. <u>The Tax Court Concluded its Opinion with Respect to the Principal Issue Herein by Repetitious Reference to Irrelevancies and Clearly Erroneous Conclusions of Fact</u>.

The remainder of the Tax Court's opinion consisted basically of a repetition of irrelevant factors appearing earlier in the opinion, conclusory statements as to its ultimate conclusions in this case, and further clearly erroneous findings of fact. For the purpose of completeness taxpayer will touch on each point made by the Tax Court in the remainder of its opinion.

The Tax Court stated that for the taxable year 1967 taxpayer continued to charge the same amount as dues as in the prior year, notwithstanding the repeal of the excise tax. (R. 201) Taxpayer does not understand why it was obliged to charge less or more by reason of a repeal of an excise tax in order to qualify amounts taken in as assessments as contributions to capital under section 118. Certainly the Tax Court gives no reason.

The Tax Court then stated that for the taxable year 1968, taxpayer increased the amount of dues without providing any breakdown with respect to how much, if any, was deemed to be "assessments". (R. 201) This is a misleading statement. What happened was that dues and assessments were lumped together under one category, dues, for the reason that there were no changes in the total payments due from the members except in the cases of certain minor classes of membership. This failure to segregate dues from assessments occurred

only for the taxable year 1968 and was not repeated for any year either before or after the years in issue. Certainly, by the taxable year 1968, a pattern of collection of dues and assessments had become well enough established so as to fall within the ambit of Cambridge Apartment Building Corporation, supra. The Tax Court would expect the taxpayer to thread the needle of accounting perfection in order to continue to qualify the assessments as capital contributions. Certainly taxpayer should not be assessed a $23,000 tax deficiency because one of taxpayer's officers or employees felt it would be superfluous to list dues and assessments separately where they had been changed only insubstantially and the insubstantial changes were specifically explained in the president's covering letter.

The Tax Court next points out that in computing its taxable income for the taxable year 1968 on its income tax return, taxpayer initially excluded an amount which apparently represented reflected net additions to the plant and equipment account. (R. 201) This statement is supported only by the Tax Court's comparison of the plant and equipment account in the amount of $13,775.46 with the amount initially excluded by taxpayer of $13,900.48.

What taxpayer did on its tax returns does not decide any issue in this case. If one were to follow the Tax Court's implication, a substantial portion of all tax refund litigation would cease because taxpayers would be bound by what

appeared on their tax returns. At the time taxpayer prepared its tax returns for the years in issue, the principal issue presented by this case did not have such a clear resolution that taxpayer could not have misinterpreted the law in determining what constituted a contribution to capital for its purposes. It should be remembered that Minnequa University Club, supra, was not decided until well after taxpayer's returns for the years in issue were due. Until the decision in that case there were very few guidelines for taxpayer to follow. Accordingly, taxpayer may have erred in preparing its tax returns, and that error was in the Commissioner's favor.

The Tax Court continued with an observation that taxpayer was now seeking capital-contribution treatment "not on the basis of capital expenditures as described in section 4243(b), but on account of other items such as deposits in the savings account and the retirement of swimming pool bonds". (R. 201) This statement again shows the Tax Court's failure to recognize the difference between what taxpayer may have reported on its return and what taxpayer argued in a court case.

Taxpayer's argument that the full amounts credited to the assessment account should have been excluded from gross

income on the basis that they were paid not only for capital improvements of the type contemplated in the plant and equipment account, but also on the basis of deposits to the Schenectady Savings Bank savings account as well as retirement of swimming pool bonds, was based on the expenditures theory of Lake Petersburg Association, supra. That case has not been reversed and despite the Tax Court's studied refusal to discuss it in the proceedings below was clearly applicable here. Surely, if taxpayer discovered in 1974 that its tax situation in 1967 or 1968 fell within the purview of the principles stated in Lake Petersburg, it should not have been precluded from arguing that those principles applied to it.

The Tax Court indicated that taxpayer failed to prove how the amount credited to the assessments account was computed. (R. 202) It should be noted that while amounts credited to the assessments account did not exactly equal amounts deposited in the savings account for the years in question here, these amounts were very close and, according to the testimony presented, were related. (R. 66-67) Furthermore, it seems clear that beginning with the taxable year 1969 the amounts credited to the assessments account exactly corresponded to the amounts paid into the savings account and that, therefore, the direct connection between the assessments account and the segregated savings account was at least inferentially

established for the years in issue. In any event, as has already been discussed, even assuming that taxpayer failed to show a direct relation between the assessments account and the savings account, this failure would go only to the question of earmarking. See pp. 44-46, supra.

The Tax Court next stated in pertinent part as follows:

> A review of the record in this case fails to support the petitioner's claim that its members knowingly made a contribution to the capital of the Club with the understanding that such contribution would be restricted as to its use. . . .
>
> In adopting the so-called dues structure, there was no commitment to the members with respect to the segregation or expenditure of the revenues resulting therefrom. Furthermore, the petitioner did not restrict itself in the use of such funds. [R. 202]

The Tax Court reached these conclusions notwithstanding the overwhelming evidence that taxpayer's members did have knowledge that taxpayer had an assessments policy and notwithstanding that the Tax Court specifically elevated much of the evidence presented with respect to this knowledge to specific findings of fact. See pp. 9-12, 43, supra.

The Tax Court next dwelt on taxpayer's characterization in certain financial statements of amounts it received as "REVENUE" and of amounts it paid out as "EXPENSES", the difference being classified as "NET INCOME". (R. 202-203) As has already been pointed out financial records must be adjusted to arrive at tax records. See pp. 46-47, supra. In addition, it can safely be assumed that taxpayer's members were not tax

lawyers or accountants. The fact that taxpayer's members may have received statements that showed taxpayer's cash flow has no bearing on whether "REVENUE" should be considered gross income within the meaning of section 61, whether "EXPENSES" should be considered deductible items under the various provisions of the Internal Revenue Code, or whether "NET INCOME" should be considered taxable income within the meaning of section 63. Surely the Federal income tax law is not yet so intrusive in everyday life that a social club and its members must discuss all financial matters in terms of definitions from the Internal Revenue Code.

The Tax Court next stated that upon repeal of the excise tax taxpayer "failed to adjust charges to its members in order to provide additional funds for the operation of the Club, as well as the purchase of the club property". (R. 203) Taxpayer does not understand the significance of this statement. In any event additional funds were automatically provided by the fact that taxpayer now had an additional 20 percent of its dues free for its purposes.

The Tax Court also stated that there was no commitment to dedicate any amount to the purchase of the property used by the taxpayer. (R. 203) In fact, amounts were being set aside in the savings account for the anticipated purchase of the property. While these amounts may not have been

committed in the sense that taxpayer was, at the time of collection, legally bound to pay them over to the General Electric Realty Corporation, it would seem that under general corporate fiduciary principles taxpayer, through its board of directors was committed to its members to apply those amounts to the purchase of the property used by taxpayers. The record is replete with references to the anticipated use of the funds in the savings account for the purchase of that property. In fact, during the years in issue there were no withdrawals from the savings account except for the down payment for that purchase. In addition, taxpayer would have been foolhardy if it had not started to accumulate funds for the anticipated down payment on that property.

The Tax Court's next statement was simply incredible and further showed how cavalierly the Tax Court regarded its fact-finding duty in this case. The Tax Court flatly stated:

> Except for the withdrawal of the downpayment from the savings account in the Schenectady Savings Bank, there have been no payments from this account for any purpose. [R. 203]

This is just plain wrong as even the most cursory review of the bankbook for the savings account shows. Thus, on March 27, 1969, taxpayer withdrew $25,131.50. (Ex. Vol. 76) While the reason for this withdrawal was not brought out at trial, the fact of withdrawal indicates that it was made for <u>some</u> purpose and it may be inferred that since it

was made on March 27, 1969, or almost exactly one year after the initial down payment, it constituted an additional payment on the mortgage with respect to the property purchased from the General Electric Realty Corporation. After this withdrawal there were additional withdrawals on September 30, 1969, November 23, 1970, and a final close-out of the account on August 25, 1972. (Ex. Vol. 76, 77)

The Tax Court then implied that the funds accumulated in the savings account could have been expended at any time to meet operating costs. (R. 203) Surely, upon authorization by the board a withdrawal could have been made to meet operating costs. But the same could have been done by the board of directors in Minnequa University Club, supra. And in either case it could reasonably be expected that a member bringing an action against the board of directors would have had a good argument that the board members would have been liable for violating their fiduciary duty to apply the money for the specific purposes that had previously been related to the members. In a word, taxpayer's board could have violated its trust with respect to taxpayer's members, but such a violation would not have been a basis for including the assessments in taxpayer's gross income.

The Tax Court found that the records showed that at most the taxpayer decided to keep the savings resulting from the

excise tax in order to provide additional funds and that the members had no choice in the matter. (R. 203-204) Again, taxpayer points out that this case involves contributions to capital under section 118 and not the applicability or inapplicability of an exemption under a repealed excise tax statue. The fact remains that members paid amounts to the taxpayer, that the amounts were denominated dues and assessments, that the amounts collected as assessments were applied for capital purposes, and that as such there was an element of a capital contribution in the dues and assessments. As for the Tax Court's comment that the members had no choice in the matter, they had as much choice in the matter as shareholders of any ordinary corporation or, for that matter, the electorate in a political election. Taxpayer was not operated dictatorially and taxpayer's records were available to its members. If the members did not like what taxpayer's board was doing, they could have elected another board to change matters accordingly.

The Tax Court next pointed out that although the excise tax applied to all classes of members, only the regular members could have brought the matter to a vote if opposed to this form of an indirect increase in the dues. (R. 204) The significance of this fact escapes taxpayer. As was pointed out in Minnequa University Club, supra, whether a

member had voting powers was not relevant to resolution of the question here.

With respect to the principal issue here, the Tax Court made its final point that monthly charges, whether termed "dues", "assessments", or "excise tax", were treated the same, as revenues received in consideration for goods and services. (R. 204) In its view of the facts, the Tax Court could as easily have stated that monthly charges to the various classes of members, whether termed "dues", "assessments", or "excise tax" were treated the same, as revenues received in consideration for capital purposes. But even on the Tax Court's view of the facts, which is contrary to the record, all that can be said is that taxpayer has not properly earmarked for capital purposes amounts received as assessments. Thus, even under the Tax Court's erroneous factual view the resolution of the principal issue in this case required an allocation under the principles of Bear Valley and not a finding that no part of the assessments constituted a contribution to capital.

5.2.8. The Tax Court Committed Reversible Error by Excluding Testimony as to the Understanding and Belief of the Members Concerning the Purpose of Assessments.

Taxpayer attempted to present testimony which would have shown that taxpayer's members believed that amounts they

paid to taxpayer as assessments were to be set aside for capital purposes. (R. 113, 131, 133, 138] Such testimony would have provided evidence that taxpayer's members intended that amounts denominated as assessments were to have been set aside for capital purposes.

The factor of the appropriate intent has been considered in the Commissioner's own rulings as the absolute prerequisite for the existence of a capital contribution in factual contexts similar to that here. Rev. Rul. 75-370, 1975-35 I.R.B. 6; Rev. Rul. 75-371, 1975-35 I.R.B. 7. The Tax Court has itself considered such an intent to be important. For example, in The University Country Club, Inc., 64 T.C. No. 45, CCH Tax Ct. Rep., Dec. 33,277 at 2764 (June 23, 1975), the Tax Court considered the failure to offer shareholders' testimony concerning intent as a factor in finding that certain payments were not contributions to capital.

Despite the importance of the factor of intent, the Tax Court sustained each of the Commissioner's objections when taxpayer sought to present testimony regarding the states of mind of taxpayer's members with respect to this question of intent. Certainly such testimony would have been relevant and material. In addition, the testimony would not have been hearsay since it came within a long-established exception to the hearsay rule. E.g., 6 J. Wigmore, Evidence §§ 1714-1731

(3rd ed. 1940). Nevertheless, the Tax Court gave no valid reason for excluding such testimony.

6. Conclusion

For the foregoing reasons, the decision of the Tax Court should be reversed.

Respectfully submitted,

J.P. JANETATOS
ROBERT A. FESJIAN
815 Connecticut Avenue, N.W.
Washington, D.C. 20006
(202) 298-8290

7. Addendum

Section 118, Internal Revenue Code of 1954

SEC. 118. CONTRIBUTIONS TO THE CAPITAL OF A CORPORATION.

(a) General Rule.--In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) Cross Reference.--

For basis of property acquired by a corporation through a contribution to its capital, see section 362.

Section 7701(a)(8), Internal Revenue Code of 1954

SEC. 7701. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof--

* * *

(8) Shareholder.--The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

* * *

Treasury Regulations §1.118-1 (26 C.F.R.)

§1.118-1. Contributions to the capital of a corporation.--In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or

other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

## 8. CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing three copies thereof on this 8th day of October, 1975, in an envelope, with postage prepaid, properly addressed to him as follows:

Mr. Scott P. Crampton
Assistant Attorney General
Tax Division
Appellate Section
United States Department of Justice
Washington, D.C. 20530

Robert A. Fesjian
Attorney
815 Connecticut Avenue, N.W.
Washington, D.C. 20006
202-298-8290